TIM HADDOCK

Day Trading with Heikin Ashi Charts

Day Trading

with

Heikin Ashi Charts

by

Tim Haddock and Ravi Kapoor

traderhaddock@gmail.com

Disclaimer

Trading and especially day trading offers great profit potential but can involve a high degree of risk. If you engage in trade stocks or other financial instruments you have to be aware of the inherent risks. Do not trade with capital you cannot afford to lose. The strategies outlined in this book are for educational purposes only and do not constitute a recommendation to buy or sell any financial instrument. Past performances are no indication to future results.

Acknowledgement

We have created all charts using the Think or Swim platform as provided by TD Ameritrade - 2013Â© TD Ameritrade IP Company, Inc.

Other screenshots of the trading platform are of the same source.

Table of Contents

Why we wrote this book

Like many of you who started trading as a way to make some money on the side or to pursue the goal of financial independence we have been collecting and reading a ton of books on trading.

From the classics like Edwin Lefevre, *Reminiscences of a stock operator* or Charles MacKay, *Extraordinary Popular Delusions and The Madness of Crowds* to the modern books heavy on mathematics. One of the more recent books which we found to be an excellent guide to trading strategies is John F. Carter, *Mastering the Trade*.

Yes, we have learned a lot from those books, though we did not find the holy grail of trading. We have seen the development of different types of charts and the creation of a myriad of technical indicators, facilitated by the advent of the PC making all these tools accessible to every trader.

Some technical indicators did indeed work â€“ at least for a while. Then after a period of uselessness they worked again â€“ for a while. Back testing helped to find what worked in the past, naturally without any guarantee for future results. Depending on the look back period you got totally different results. With a skillful selection of the look back period you could promote any indicator or system as the ultimate system and make tons of money selling it. Some systems were selling for several thousands of dollars making the creators rich without the need of doing a single trade. This, of course, was a constant source of frustration for the hopeful souls purchasing those systems and seeing their capital erode using them.

One thing remained the same over the years, trivial

as it is. Stocks or any other financial trading instrument moved either up, down or sideways. And when they moved, they moved in trends, some of them in a more orderly fashion, others with wild swings scaring the daylights out of a novice trader. Retracements are part of the game, since nothing moves straight up or down. The big question always was, is that just a retracement, giving you the opportunity to buy the dips or is it the beginning of a reversal? If you have the correct answer you are on the way to riches.

Whether you consider a move a trend or a just a retracement depends on the time frame you are watching. What looks like a nice tradable trend on a daily chart, may just be a retracement on the weekly chart. The quest we are pursuing with this book is to help you to identify an emerging trend in its infancy and ride it as far as you could within the timeframe of your choice. We will show you a solid strategy which you can pursue with readily available tools within your charting package or trading platform. All this without the need of manipulating spread sheets which would be unpractical in a day trading situation. This strategy focuses on riding the trend for as long as possible while tightly limiting the risk.

We will demonstrate our strategy on the very elaborate and versatile Think or Swim platform (ToS) which is supported by the online brokers TD Ameritrade and thinkorswim.com. This is simply

because itâ€™s the platform we are familiar with and we cannot cover other platforms in this limited space. But you may certainly use any other broker or platform you like. You should be able to duplicate virtually all the settings we are using for the Heikin Ashi Trend Trading Strategy.

In case you could not see the charts provided properly on your device, donâ€™t hesitate to shoot us an email (traderhaddock@gmail.com) and we will make sure you can get access to them.

Trading vs. investing

An investor typically continues to hold on to his investments for a long time, sometimes for years or even decades. As long as he is convinced about the fundamental soundness and future prospects of the company he is investing in he will hold his shares through periods of declining stock prices. He might even buy more shares on dips. And along the way he will cash in dividend payments and benefit from stock splits. In the long run he will average returns at or somewhat above the returns of the S&P 500, letâ€™s say anywhere between 10 and 20% annually on average. There is always the danger that he falls in love with a stock and will never consider to sell it just for profane money reasons.

A trader on the other side aims to take advantage of the ups and downs of the market. This requires regular monitoring of the markets and the ability of the trader to actually call the shots when to buy or sell. To arrive at these decisions and to be successful in the long run he needs to have some rationale or a trading plan with rules when to enter or exit. Trading decisions from the gut might work as well sometimes but are far from being reliable and are therefore not recommended. It is essential

to keep the feelings of fear and greed in check. Failing to take profits when they are available is the biggest danger to your capital.

Swing traders look for holding periods of between several days to several months. A good swing trader with a solid system can substantially exceed the returns achieved by the investor.

At the short end we have the day trader who wants to take advantage of intraday movements and exits all his positions before the close of the trading day. Buying and selling or short selling and covering within the same day will create a daily cash flow. At the end of the trading day the trader will know his result as a Dollar amount. The Dollar amount is the only reasonable yardstick for measuring your success. Percentage numbers donâ€™t make much sense in this context.

He needs to constantly monitor the market, essentially spend his day in front of the screen. This is like a job or a business and the day trader is well advised to treat his trading accordingly.

Trend following vs. contrarian approach

To be a contrarian means not to follow the crowds. Crowds and herds have a pretty lousy image on the intellectual front. We immediately think of the stupid behavior sheep or of the frantic bull run of Pamplona. Being a contrarian certainly has its merits in investing. Like discovering out of favor stocks when they are cheap and riding them up over months or years.

In short term trading a contrarian would be someone who can call the bottoms and tops of swings before anyone else. If you can achieve that on a consistent basis, you are a hero. It is also intellectually rewarding, but is it realistic?

We donâ€™t think so. And our aim is to make money consistently, becoming a hero is not one of our goals. And the intellectual satisfaction does not necessarily line our pockets. Thatâ€™s why we are taking the trend following approach. After all, just think of Pamplona and the raw energy associated with a bull run. We strive to get into a trend as early as possible and to ride it for as long as possible. Not standing in the way of the charging bulls is the recipe for our financial health.

Day trading

If you still have a day job forget about day trading, there is no way you can combine the two. At least one of the two activities will suffer from underperformance, if not both.

Whether you can join the ranks of day traders depends first of all on your account size. According to the FINRA (NASD) regulations you need to maintain a minimum of $25,000 of equity in your account.

When you do your first day trade you will get a warning message from your broker explaining about the implications and once you have done your fourth day trade within any 5 successive business days you will be labeled a pattern day trader. This means that from now on you will have to maintain a minimum balance of $25,000 at all times.

As a day trader you have to be aware that this activity was an exclusive domain of financial institutions until just a few years ago, like Goldman Sachs, Morgan Stanley, Knight Capital and many more. The dramatic development of the internet and the advent of online discount brokers with ever improving trading platforms has democratized and

internationalized the scene. Day traders can be found among students, housewives and pensioners around the world. There seem to be very active day trading groups with smart individuals in India and China trading the US stock markets. All you need to join the game is a funded account, a lap top and an internet connection. Well, and a solid strategy, of course.

Donâ€™t underestimate either the new or the old competition. The old competition, the big firms employing the smartest traders money can buy, supported by hordes of highly paid analysts and equipped with the best in hardware and sophisticated software is still well and alive. And not to forget, they have a backing of capital you could only dream of. Donâ€™t even think of trying to outsmart them. Itâ€™s a losing proposition.

Now, with that formidable competition out there, does it mean you are crazy to take up the fight and try to make a living off the markets? Not at all. You need not be afraid. All these formidable market participants are trading for themselves and none of them can predict the future just like everyone else. They do not operate with the same systems or donâ€™t come to the same conclusions about whether or not a stock price is too high or too low. Thatâ€™s why we see transactions happening all the time. And not only you, but also the big boys incur a loss once in a while, thatâ€™s part of the business.

You may have experienced that one of your stops has been hit and the price rebounds right away. Nobody has singled you out specifically to get your money by running your stops. Your stops were probably just at an obvious point used by many traders. No sinister complot by the big boys. Your losses are usually your own making, be honest to yourself and donâ€™t try to explain your mistakes away.

Do you really have a realistic chance to survive in this environment? Absolutely. But you have to arm yourself with a solid strategy including money management, discipline and a proper mind set.

And most important:

Treat the market with respect

Making a watch list

You simply cannot monitor the whole market with thousands of traded stocks. You have to reduce that universe to a more manageable size. Make a list of stocks you plan to watch on a regular basis. It should be as short or long as you can handle. For us this list of trading candidates contains between 50 and 100 names and we will update this list on a regular basis. You can create this list manually with the stocks you like or you can do it systematically by scanning the whole market against your criteria. Most trading platforms allow you to do that very painlessly.

You can use a preset scan or do your own. Our criteria are trading volume, volatility, minimum stock price and whether weekly options are available.

Stocks with too low trading volume tend to have wide bid/offer spreads making them difficult to trade profitably. The risk of erratic movements increases as well. Donâ€™t waste your time or capital on these. We chose 1 million shares as the minimum trading volume.

We set a minimum volatility of 25%. If a stock just sits around all day at one level, we donâ€™t want

to waste our trading capital on it.

For the stock price we set a minimum of $30. That is just an arbitrary number, but we feel that generally you get better movement from that price level upwards than with low priced stocks. You can use whatever you are comfortable with.

Figure 1: Setting up a scan

On TOS you choose the Scan tab and then under the drop down menu load scan query choose Create new scan. The drop down options show up when you click on the little triangle in the lower right corner of that box (1). In the upper right of this page you can tell the program where to scan and with which list to intersect the result.

We have chosen All Stocks to be intersected with Weekly Options. This is a bit tricky to find. In the intersect box go to Public and Weekly options will be at the very bottom of the drop down list.

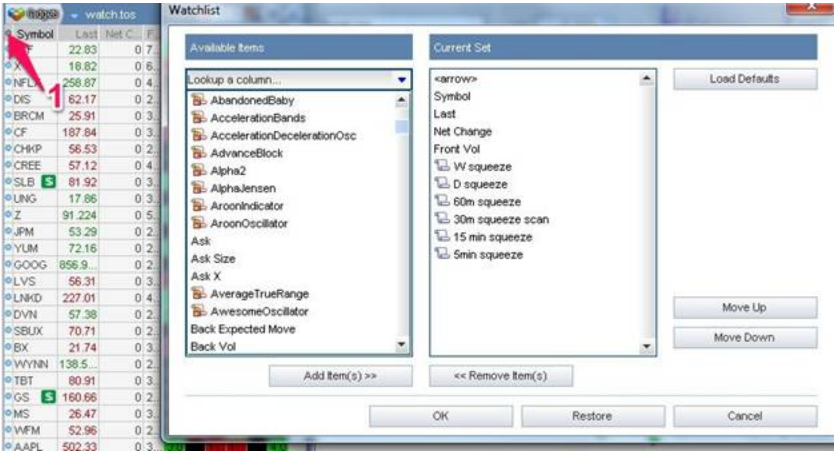
Why do we choose weekly options as a criterion?

Even if you are not even considering trading them right now, their presence is an indication that there is a good following in the stock on a continued basis.

Sort the resulting list alphabetically by clicking on the Symbol header and go through this list manually. You might add stocks you like for whatever reason. You may add your favorite ETFs, index products, currencies or some futures, like gold, bonds, crude or natural gas. Anything you trade or you think is worth watching to give you a sense of the overall market sentiment and direction. You can also delete the symbols of stocks you dislike. At this stage and only here you may allow yourself a few emotions.

Finally save the scan result as a watch list and give it a meaningful name.

Figure 2: Setting up a watch list



The watch list in TOS is very useful. Right clicking on any ticker symbol offers you many choices, from accessing a Quick chart, to note taking and even to order entry. Just go through this list of options and explore them on your own. You can also customize the watch list in many ways. To do that right click on the little dot just left of the Symbol header (**1**) and chose Customize. On the left appears a list of available items which include all technical indicators. You can add your choice to the current set to be displayed. You can also remove items you do not need to be displayed and you can change the order of the columns. We will come back to this with setting up a customized scan in a later chapter.

The Elements for the Heikin Ashi Trend Trading Strategy

In the old days, i.e. before the arrival of the PC, traders drew their charts by hand and even the simplest technical analysis tools like moving averages were a pain to calculate. The PC has changed all that and democratized market analysis. With a click of the mouse you can display your charts as line charts, bar charts, candle sticks and Heikin Ashi. Among the newer additions are monkey bars. Even mathematically challenging indicators are updated almost instantaneously and real time charting is no longer a luxury. You can have it even on your tablet or smart phone.

On the TOS platform there are more than 200 indicators you can choose from and more indicators are regularly developed. Do you need all of them? Certainly not. The problem with indicators is that they do work very well at times and then they donâ€™t work at all for a while. Thatâ€™s why many traders add more and more indicators in the hope that they confirm each other and if not they speak of divergence which itself is interpreted as a signal. Thatâ€™s where the objective turns into subjective. Or do we decide democratically based on what the majority of indicators tell us?

Pick the indicators you use very carefully and sparingly since you do not want to run into the problem of paralysis by analysis when you get contradicting signals.

The indicators are calculated with past data in the hope to predict the future. This is a lofty goal. Still there is merit to some of the indicators since they can tell us something about the current state and health of the market, which can expected to persist for a while.

For our Heikin Ashi Trend Trading Strategy we will mainly focus on two aspects for identifying trade setups, volatility and momentum. We will use a combination of Bollinger Bands and Keltner Channels and for momentum either MACD or the TTM_Squeeze indicator. Bollinger Bands, Keltner Channels and MACD are built into almost any platform offered by online brokers. The TTM_Squeeze indicator is part of the ToS platform free of charge, for other platforms it can be purchased. We will show you a workaround which is not as comfortable, but at least itâ€™s free.

Bollinger Bands

Bollinger Bands have been developed by John Bollinger in the 1980s and are widely used and well documented. We think there is no need to go into details which you either do know already or

which you can easily look up in many books on technical analysis or on the internet.

Let us just summarize that Bollinger Bands consist of a simple moving average with a default length of 20 periods and a upper band and a lower band which are 2 standard deviations above resp. below this moving average. When volatility decreases the bands will narrow towards the moving average.

Bollinger Bands are supported by practically all charting packages and trading platforms. You can stick with the default settings.

Keltner Channels

Keltner Channels are quite similar to Bollinger Bands, but use instead of standard deviation the Average True Range = ATR which is fluctuating not as wildly as the standard deviation resulting in a much smoother appearance and more constant width.

Keltner Channels are pretty much standard and you should find them on most charting packages and trading platforms. Stick with the default settings as well which uses a length of 20 periods and factor 1.5 for the ATR.

Squeeze

Whenever the Bollinger Bands contract to within the Keltner Channel we observe a serious decline of volatility. John F. Carter in his highly recommended book â€œMastering the Tradeâ€